Good Policies for Bad Governments

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Policy evaluation must consider three key players.

- Private actors
  (e.g., workers, consumers)
- Public actors
  (e.g., regulators, politicians, judges)
- Institutions
  (e.g., democratic elections, free speech, competitive markets)

1. Private actors

May make suboptimal decisions.

Policy-relevant sources of mistakes…

- Bounded rationality.
- Sensitivity to framing.
- Slow learning.
- Self-defeating propensity for instant gratification.

2. Public actors

May not act in the best social interest.

- Prone to same biases as private actors (particularly over-optimism; easy to miss unintended consequences of policies).
- Prone to maximize self-interest.
- Elected by manipulable, quasi-rational voters.

History is rife with bad policies implemented by both well- and poorly- intentioned governments.

3. Institutions

Competition and democracy may not help.

- Demagogues can subvert elections.
- Free speech costs $100,000 per minute.
- Product advertising can mislead.
- In many settings, increased competition will increase mark-ups (Gabaix & Laibson 2003)

On the other hand, in *perfectly* competitive markets, sellers will compete to offer Dutch books, eliminating exploitation! (Laibson and Yariv 2003)

Goal: Paternalism without all of those calories (P-Lite).

- Shouldn’t harm rational agents.
- Shouldn’t encourage black markets.
- Shouldn’t discourage personal agency.
- Should be robust to unforeseen contingencies.
- Shouldn’t empower corrupt governments.
- Should be robust to bad governance.

Good news:

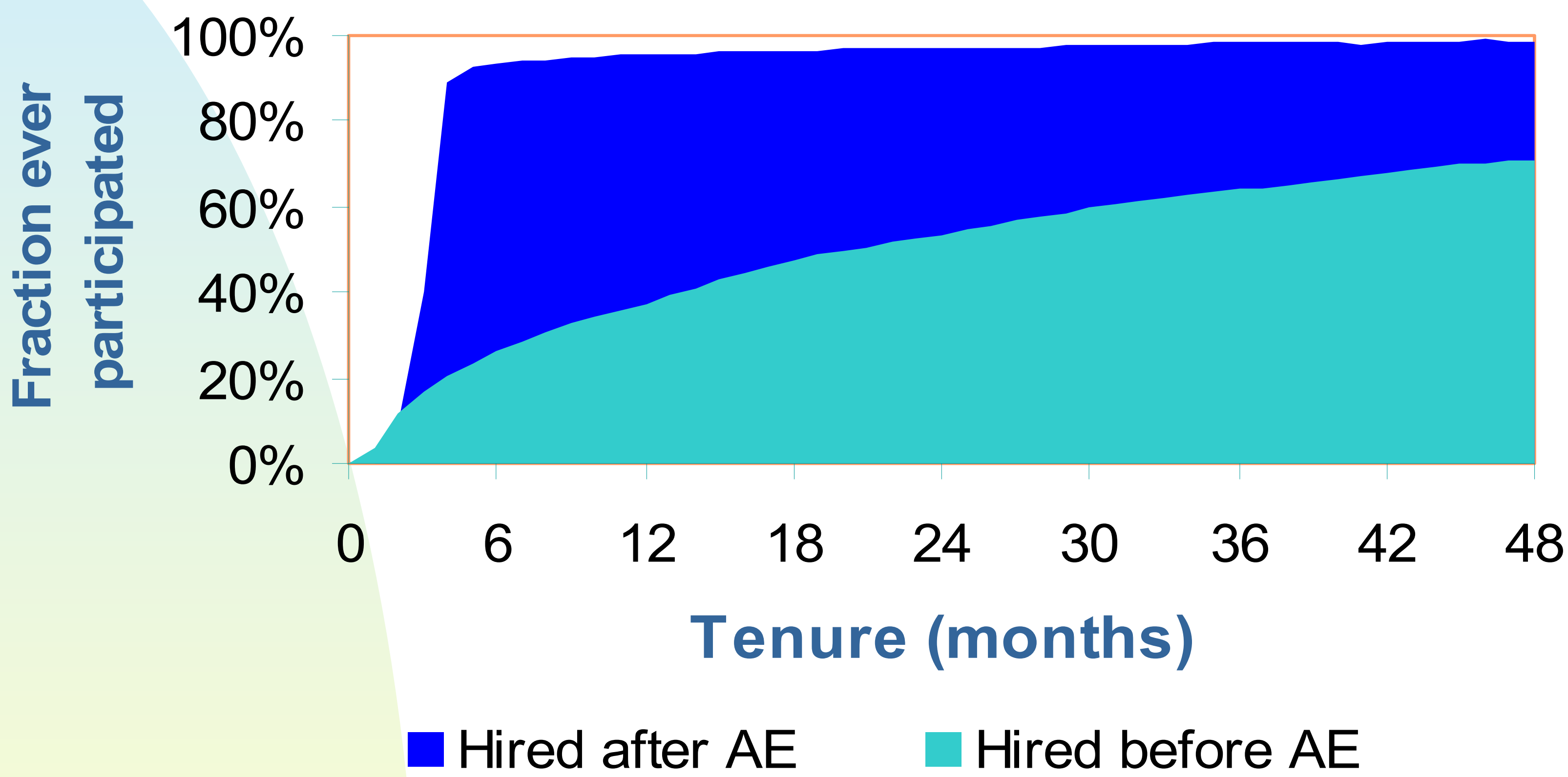
It's easy to help private agents make good decisions *without* using coercion or strong paternalism

Weak interventions can powerfully channel and transform behavior (Ross and Nisbett 1991).

Examples:

- Defaults, Automaticity (SMarT)
- Precommitments (even non-binding ones)
- Norms
- Deadlines (Active Decisions)
- Frames

401(k) Participation by Tenure:

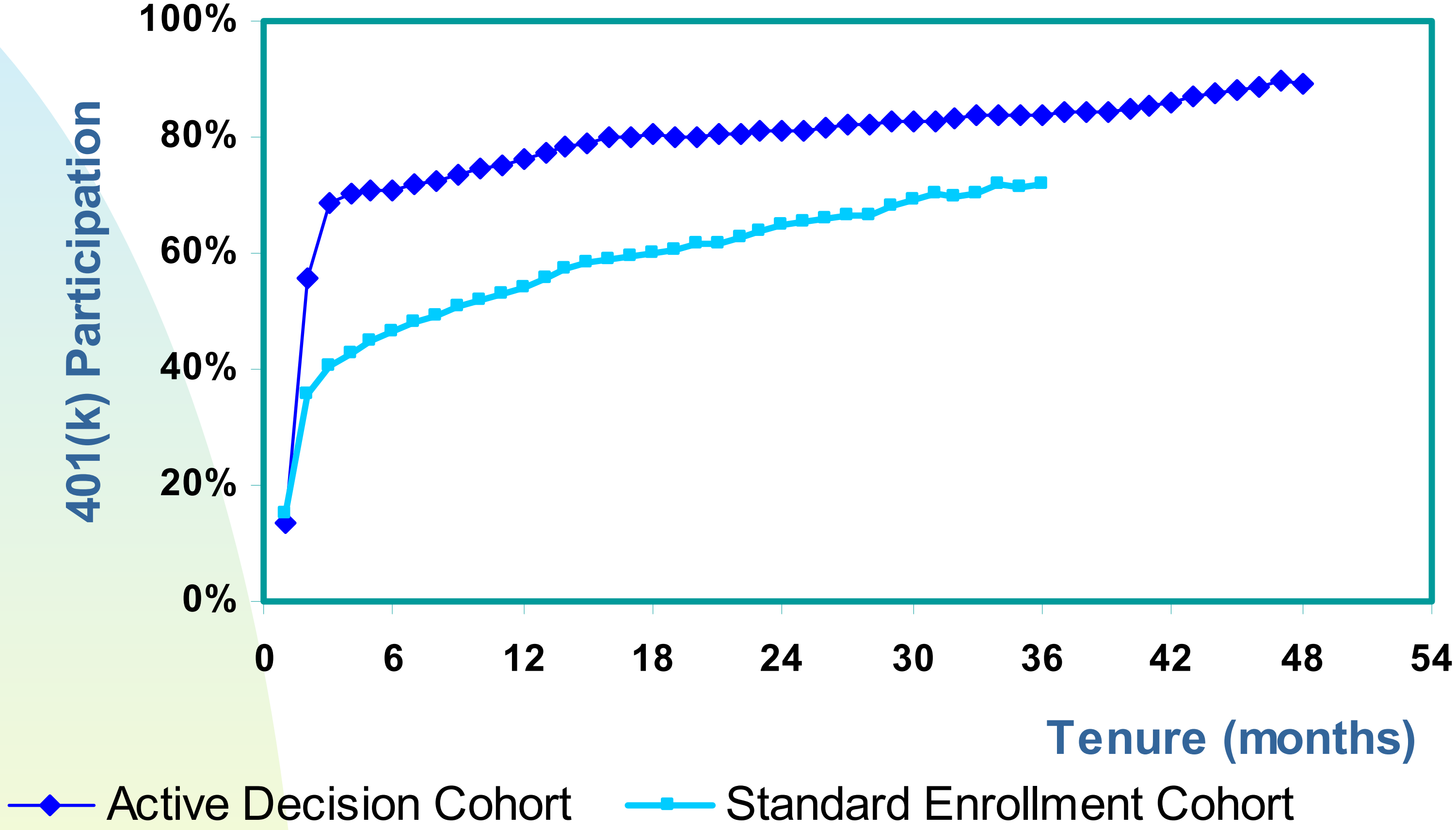


Source: Choi et al. 2002.

Active Decisions (Choi et al 2003)

- “Active decisions” are techniques for encouraging investors to stop procrastinating.
- “Active decision” requires that new employees actively decide whether to enroll in their 401(k) plan.
- Under active decision there is no default election.
- Active decision leads to a doubling in participation rates.

The Impact of Active Decisions



Source: Choi et al. 2003.

When should the government use defaults?

- Regulators have a clear understanding of the consumer's best interests.
- Those interests are relatively homogeneous.
- The decision that's being made is complex, making it useful for the consumer to have a fall-back default.

When should the government use active decisions?

- When the decision is important.
- When the consumer has priorities that the regulator may not know about.
- When those priorities are sensible.
- When the consumer is likely to make a good decision.
- When the consumer will feel good about being encouraged to stop procrastinating.

Benign paternalism (Choi et al 2003):

Policies should channel behavior without eliminating consumers' ability to choose for themselves.

- Libertarian paternalism (Sunstein and Thaler 2003)
- Asymmetric paternalism (Camerer et al 2003)
- Optimal paternalism (O'Donoghue and Rabin 2003)

Five examples of behavioral policy applications

- Encouraging saving
- Regulating asset allocation
- Privatizing social security
- Stimulating aggregate demand
- Targeting a positive inflation rate

1. Encouraging saving

Convergent pieces of evidence imply that US households are saving too little for retirement. Government should:

- Require large firms to offer 401(k)'s
- Require firms to adopt one of two enrollment rules:
  - Age-specific saving rate defaults
  - Active decisions for saving rates
- Require firms to adopt defaults for asset allocation

2. Regulating asset allocation

Investors hold too much wealth in own-company stock. Many mutual funds charge non-competitive management fees. Government should:

- Require firms to implement a default rebalancing of 401(k) assets once a year, to achieve a 20% own-stock cap.
- Require mutual funds to publish management fee warning labels in the prospectus and in advertisements.
- Appoint a Financial Advisor General

The annual management fee for "NAME OF FUND" is 1.5% of your investment. If you had \$50,000 invested in "NAME OF FUND" then you would pay \$750 per year in management fees.

3. Privatizing social security

The US is not prepared for the demographic transition and politicians are masking this problem by integrating off- and on-budget accounts. The government could:

- Create private accounts, so Social Security revenues stop being subsumed in the budget.
- Introduce defaults to encourage additional deposits into these private accounts.
- Introduce formal caps on management fees for Social Security accounts (75 basis pts)
- Require diversification and restrict investment to bread-and-butter asset classes

4. Stimulating aggregate demand

From time to time, the government needs to stimulate demand with tax cuts. When doing this, the government should follow these precepts. Stimulatory tax cuts should:

- Increase household liquidity in spending accounts (not saving accounts).
- Generate a stream of new liquidity for the target households
- End after a year or two.
- Be framed as a windfall to be spent quickly.

5. Targeting a positive inflation rate

Nominal wages seem to be downward sticky (unlike real wages!). In downturns, firms cut employment instead of nominal wages. Government should:

- Consider a target inflation rate which is slightly greater than zero.
- (Countervailing considerations: menu costs, money illusion, Friedman’s rule, capital-tax distortions.)

Policy evaluation

Behavioral economics also implies a new approach to policy evaluation.

- Because of slow learning, many policies (e.g., tax cuts) will have different effects in the short-run than in the long-run.
- Two examples:
  - 401(k)'s and asset shifting
  - Dividend tax cuts

Forecasting

Economists give too little attention to forecasting.

When economic models fail to make good forecasts, economists tend to keep the models and give up forecasting.

- Forecasting should regain center stage.
- We should pay greater attention to psychological variables, like consumer confidence.
- And we should work to develop new survey instruments that measure psychological variables with promise.

Conclusion

- Benign paternalism: channel behavior without eliminating the ability the choose for oneself.
- Good policy for bad governments.
- 5 policy proposals.
- Also, recommend healthy skepticism.
- New policies should be tested with small-scale field experiments.
- No doctor would prescribe a drug that only worked in theory.